No. 461

In the Supreme Court of the United States

OCTOBER TERM, 1950

STACY C. MOSSER, SUCCESSOR TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST, AND JOHN W. GUILD, INDENTURE TRUSTEE, ETC., PETITIONERS

v.

PAUL E. DARROW, FORMER TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM OF SECURITIES AND EXCHANGE COMMISSION IN SUPPORT OF PETITION

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CITATIONS

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OPINIONS BELOW

The opinion of the Court of Appeals (R. 675–691) is reported in 184 F. 2d 1. The memorandum opinion of the District Court (R. 577–585) is not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 14, 1950 (R. 692). A petition

for rehearing was denied by the Court of Appeals on September 21, 1950 (R. 727). The petition for a writ of certiorari was filed on December 18, 1950. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTION PRESENTED

Whether a reorganization trustee should be surcharged for profits realized with his knowledge and assistance by his subordinates from trading in securities of the debtor's subsidiaries, particularly where the trustee was himself engaged in purchasing the same securities for the benefit of the estate and purchased some of them from these employees at a profit to them.

STATEMENT

The reorganization proceedings here involved were begun under former Section 77B of the Bankruptcy Act (48 Stat. 911) and subsequently made subject to various provisions of Chapter X, at which time the Commission became a statutory party pursuant to Section 208 (11 U. S. C. § 608). As such the Commission supports the petition herein. The petitioners are the successor reorganization trustee and the indenture trustee for the collateral trust bonds of one of the debtors.[1]

[1] The petition for a writ of certiorari was filed in the names of Stacy C. Mosser, as Trustee of both debtors, and John W. Guild, the indenture trustee of collateral trust bonds of Federal. Respondent urges that this Court is without jurisdiction, contending that the petition was not filed by proper

The debtors, Federal Facilities Realty Trust ("Federal") and National Realty Trust ("National"), are common law trusts (R. 577) which were organized in 1929 and 1930, respectively, by Jacob Kulp and Myrtle Johnson as real estate

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parties since Mosser had resigned as trustee of both debtors prior to the filing of the petition and since, in respondent's view, the indenture trustee is an "intermeddler" without the power to file a petition (Brief, pp. 6–10).

The chronology of the trusteeships is as follows: Mosser became trustee of both debtors on August 13, 1943 (R. 350). On November 7, 1949, Joseph Schwartz and Frank W. Whiston were appointed cotrustees with him of Federal and National respectively. Mosser resigned as cotrustee of National on October 17, 1950, but remained as cotrustee of Federal. On October 26, 1950, the District Court authorized the filing of the petition for certiorari in this case by Mosser and Schwartz on behalf of Federal and by Whiston on behalf of National. Thereafter, on December 1, 1950, Mosser resigned as trustee of Federal. This petition was filed on December 18, 1950. (Appendix to Respondent's Brief in Opposition, pp. i–ix.) The petition was filed in the name of Mosser, who was the trustee of record in the Court of Appeals. The present trustees are moving to be substituted on the petition in the place of Mosser. The present trustees had been duly authorized by the Bankruptcy Court to file the petition, and their filing it in the name of the trustee who had resigned has support in the accepted practice with respect to the continuation of litigation after a transfer of interest. See *Bragg* v. *Gerstel*, 148 F. 2d 757, 758 (C. A. 5); *Fox* v. *McGrath*, 152 F. 2d 616, 618–619 (C. A. 2). Cf. Rule 25 (c) of the Federal Rules of Civil Procedure. Since under Section 46 of the Bankruptcy Act (11 U. S. C. § 74) and the District Court's order the successor trustees had authority to continue the litigation, the use of the name of the trustee who had resigned is, at most, a formal defect, and the substitution of the present trustees is proper. *Gates* v. *Goodloe*, 101 U. S. 612, 613–614; *Bowden* v. *Johnson*, 107 U. S. 251, 264. In view of the facts of this case, there is not

holding companies to control and to operate 27 companies, each of which owned a parcel of real estate with a building thereon. Although Kulp retained large blocks of securities, substantial amounts of the securities of both debtors are publicly held.[2]

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presented here the problem involved in *Davis* v. *Preston*, 280 U. S. 406, and *Snyder* v. *Buck*, 340 U. S. 15.

Irrespective of the standing of the debtors' trustees, the indenture trustee of Federal as a party to the petition presents the merits of the issue and there is no substance to respondent's contention regarding the standing of the indenture trustee. Section 206 of Chapter X (11 U. S. C. § 606) expressly provides that "the debtor, *the indenture trustees*, and any creditor or stockholder of the debtor shall have the right to be heard *on all matters arising in a proceeding* under this chapter" (italics added). This section has been construed to give these parties the absolute right to be heard in all matters arising in the proceeding which may affect their interest, and this right carries with it the right to appeal. See *Young* v. *Higbee Co.*, 324 U. S. 204, 210–213; *Matter of Keystone Realty Holding Co.*, 117 F. 2d 1003, 1005 (C. A. 3); *Dana* v. *SEC*, 125 F. 2d 542, 543 (C. A. 2); see also *In re South State Street Bldg. Corp.*, 140 F. 2d 363, 367 (C. A. 7), certiorari denied, 322 U. S. 761. In this case the indenture trustee participated in the proceedings in the district court and in the court below (R. 499, 568–569, 582, 585–586, 697) and the decision below clearly affects the interest of Federal's bondholders on whose behalf the indenture trustee has a statutory right to be heard and with it the right to seek review.

[2] The capital structure of Federal consists of $558,300 in principal amount of collateral trust bonds, of which $84,000 have been reacquired by Federal, and 100,000 units of beneficial interest. Of these securities, $188,200 in principal amount of bonds and 37,642 units of beneficial interest are publicly held. National has no funded debt. Its outstanding securities consist solely of 46,636.1 units of beneficial interest, of which 25,874.5 units are held by the public. (R. 518, 578, 582, 584.)

The subsidiary companies had been promoted principally by Kulp and Myrtle Johnson (R. 578–579). Land acquisitions and the construction of the buildings had been financed through the public sale of bonds, of which there were more than $7,000,000 face amount outstanding, while the capital stock was retained by Kulp and members of his family. Subsequently, when the value of real estate properties was declining and the maturities of several bond issues were imminent, the debtors were organized to acquire the equity in these companies and the bondholders were offered securities of the debtors for their bonds in the subsidiary companies (R. 578–579, 681). While some exchanges were made, the outstanding bonds of the subsidiaries were not reduced in sufficient amounts to avoid eventual defaults and the consequent proceedings for the reorganization of the underlying companies as well as of Federal and National.

Kulp, his son, and Myrtle Johnson, were the original common-law trustees of the debtors. In 1933 they resigned following an investigation by the United States Department of Justice. At the time of his resignation, Jacob Kulp transferred to George Andresen, one of the successor common-law trustees, under a separate trust agreement, all his holdings in the top trusts and their subsidiaries for the benefit of those who had been previously induced to exchange bonds of the latter for securities of the trusts (R. 154, 517, 578).

These securities were subsequently sold at a judicial sale referred to below.

Paul E. Darrow was appointed reorganization trustee of Federal and National in 1935, and, until his resignation on August 10, 1943, he conducted the business of the debtors and managed the 27 subsidiary building companies. As manager of the debtors and the underlying properties, Darrow engaged in the purchase of bonds of the subsidiary companies at a discount for retirement. (R. 513.) During his administration, as the court below noted (R. 680–681; 184 F. 2d 1, 4–5), bonds of the subsidiaries were reduced from $7,611,700 to $5,197,100 face amount. These purchases were of the utmost importance to the debtor trusts, whose equity in the underlying properties depended in substantial measure upon the acquisition and the retirement of the subsidiaries' bonds as inexpensively and as expeditiously as possible.

Kulp and Miss Johnson were employed by Darrow, were paid regularly salaries out of the estates, and were placed in key positions in the reorganization. As found by the Special Master, Miss Johnson had supervision over the trustee's office, advised Darrow on all phases of management, and assisted him generally in the reorganization of the subsidiaries. She had charge of all records including complete data respecting the properties, income and expenditures of the debtors and their subsidiaries, and was the best in-

formed person in the organization regarding the various enterprises. Darrow depended upon her ability and judgment and regularly consulted her regarding purchases of the securities of the subsidiaries, and the allocation of funds for sinking fund operations and prices to be offered (R. 189–191, 209–211, 339, 513, 579).[3] Kulp was retained to manage the physical properties for Darrow. He also had access to all records and information and enjoyed Darrow's absolute confidence (R. 182, 199–200, 512–513).

Kulp and Miss Johnson were retained by Darrow with the express understanding that they were to be permitted to trade in securities of the debtors' subsidiaries (R. 511). Although Darrow testified that he had discussed their employment with the court and with counsel, and others, it is clear, as found by the Special Master, "that he did not specifically tell these persons that Miss Johnson and Kulp would be dealing in the securities of the subsidiaries" (R. 512). During their employment by Darrow, Kulp and Miss Johnson traded extensively in bonds of the debtors' subsidiaries and, indeed, on many occasions sold bonds directly to Darrow as trustee. Much of this trading was through Colonial Securities Cor-

[3] With respect to all but seven or eight subsidiaries Darrow had sole authority to determine prices. In the case of the other subsidiaries, maximum prices were fixed by the boards of directors or special trust committees, but Darrow usually had discretion to raise or lower the prices within prescribed limits (R. 513).

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poration ("Colonial"), a corporation wholly owned by Kulp and Miss Johnson. For a substantial period of Darrow's trusteeship, Colonial shared office facilities and personnel with the debtors' estates and dealt largely in securities of the debtors and their subsidiaries (R. 168, 513, 538–540, 579). The profits realized by them on these transactions amount approximately to $43,000, of which $8,600 was derived from direct sales to Darrow. In many instances, when purchasing from Miss Johnson, Darrow paid for the securities in advance of delivery or prior to her own purchases (R. 337–338, 520–521). Frequently, bonds purchased by Miss Johnson or Colonial were sold at a profit to Darrow on the same day, or within a few days after their purchase, and some of the bonds thus sold to Darrow had been purchased by Miss Johnson from bondholders who had come to the office to sell their bonds to the trust. Darrow made no inquiry as to the prices Miss Johnson or Colonial had paid for the securities; he asked for no accounting and made no check of Colonial's books, to which apparently he had access (R. 210–211, 341, 514–515, 538–539).

By far the largest single transaction involved the acquisition by Miss Johnson and her associates of the substantial block of securities which had been turned over by Kulp to the Andresen trust (pp. 5–6, *supra*). These were acquired by Miss Johnson at a total cost of $24,000 (R. 518)

at a judicial sale ordered by the Superior Court of Cook County, Illinois. These securities consisted of two lots, one involving $199,000 face amount of bonds of subsidiaries, the other substantial amounts of the debtors' securities.[4]

About one-half of the purchase price was obtained by Miss Johnson through a resale to Darrow of $128,700 in face amount of bonds of the subsidiaries for $12,447, although the cost to Miss Johnson for all the securities in that lot was approximately $8,000 (R. 519–521). As was his custom (R. 519), Darrow paid for these securities in advance of delivery and, as the court below stated, "it is undisputed that the checks issued by Darrow to Colonial were used in making the payment due under the bid" (R. 683; 184 F. 2d 1, 6). Additional bonds of the subsidiaries were sold by Miss Johnson to customers of Colonial, who subsequently resold some of them to Darrow (R. 522). As a result, Miss Johnson realized a total of $34,905 on the securities of the subsidiaries, or $10,701 more than she had paid for both lots, and obtained the debtors' securities at no net cost (R. 520–523, 556). The treatment of the latter securities, which may determine control over the reorganized debtors, is now pending

[4] These securities were: $286,100 principal amount of Federal bonds; 62,358 units of beneficial interest of Federal, representing over 60 percent of the equity in Federal; and 10,761.6 units of National, representing about 25 percent of the equity in National (R. 518).

before the District Court (R. 522, 557).* The surcharge of the trustee which the court below set aside includes only the profits realized on the resale of the securities of the subsidiaries.

In his report (R. 498–560), filed on April 28, 1948, the Special Master concluded that on the basis of the evidence Darrow's acquiescence and active support of the trading activities of Kulp and Miss Johnson at a time when "the trusts and their subsidiaries were attempting to retire their indebtedness as rapidly and as inexpensively as possible * * * was pregnant with potential conflicts of interest" (R. 553), and that for allowing his employees' "infidelity to inflict direct financial loss upon the trusts" Darrow was derelict in his duties as trustee (R. 554). The Special Master, accordingly, recommended that Darrow be surcharged in the amount of $43,000, representing the profits which these employees obtained as a result of their trading in securities of the debtors' subsidiaries. On consideration of the evidence and of the Special Master's report, the district court concluded that the evidence supported the findings and recommendations of the Special Master. On appeal by Darrow, the court below reversed the decision of the district court basically on the theory that, regardless of the

*In accordance with the recommendation of the Special Master, the District Court has also reserved jurisdiction to permit consideration of an additional surcharge against Darrow, depending upon the disposition of these securities (R. 556–557).

profits made by Kulp and Miss Johnson, Darrow's purchases had been beneficial to the debtor (R. 675–692).

ARGUMENT

This case involves a question of substantial importance in the administration of bankruptcy reorganization. The decision below appears to hold that a trustee who was not himself engaged in profiting from the estate cannot be held responsible for knowingly permitting subordinates in responsible positions to engage in a course of conduct in conflict with the interest of the estate. The statutory provisions and judicial decisions emphasizing the importance of a loyal and disinterested trustee in the management of a bankruptcy reorganization become meaningless if the trustee is permitted to shut his eyes to activities of his subordinates in which he himself is forbidden to engage.

1. Although under the Bankruptcy Act the reorganization trustee is not prohibited from employing officers affiliated with the estate, it is undeniable that in retaining their services the trustee may not enter into any arrangement in conflict with his fiduciary responsibility for the proper and effective administration of the reorganization. Nor is the trustee thereby relieved "of the duty of exercising care and prudence within the field left to his discretion." *United States ex rel. Willoughby* v. *Howard*, 302 U. S. 445, 452. The retention of Miss Johnson

and Kulp, whatever their competence, upon condition that they be permitted to trade in the securities of the debtors and their subsidiaries, was in itself inconsistent with the elementary dictates of common prudence. Since Darrow as trustee and as manager of the subsidiaries' properties was engaged in the purchase of bonds of the subsidiaries, the employment of Kulp and Miss Johnson under the circumstances gave them, in addition to their regular remuneration, continuous opportunities for profiting to the detriment of the estate on the basis of inside information, and thus necessarily led to divided loyalties and continuous conflicts of interests in the day-to-day administration of the reorganization proceedings. Darrow's tolerance and active support of the trading activities of Kulp and Miss Johnson, coupled with his complete failure to exercise an independent scrutiny of these activities, constitute an abdication of his supervisory duties with respect to his subordinates and a flagrant abuse of his fiduciary responsibilities for the proper administration of the estates in reorganization.

The circumstance that Darrow himself did not personally profit by the trading of his subordinates—and this apparently is emphasized by the court below (R. 685–686; 184 F. 2d 1, 7)—is beside the point. It is axiomatic that the standards of fiduciary responsibility, which exclude divided loyalties and conflicts of interests with respect to

the trustee, necessarily impose upon him an affirmative obligation not to tolerate—much less actively support—the same vices in his subordinates. Divided loyalties and conflicts of interests produce the same harm when they prevail among employees, upon whose skill and knowledge the trustee relies for the proper discharge of his own fiduciary responsibility, as when the trustee himself is involved. Accordingly, Darrow was guilty of misconduct in deliberately condoning and actively supporting a course of dealing by his subordinates which was obviously against the interests of the estate. The fact that the subordinates were in this case the original promoters and underwriters of the debtor is not the basis for imposing liability, but it does highlight the extent of the departure in the instant case from the established standards which emphasize the requirement of loyal and disinterested services by those charged with the administration of bankruptcy reorganization.

2. The decision of the court below emphasizes that Darrow's course in purchasing the securities of the subsidiaries was beneficial to the estate, and that he purchased the securities from Miss Johnson or Colonial at prevailing "market" prices (R. 681, 683, 184 F. 2d 1, 5, 6). We believe it is irrelevant that in view of the rising real estate market the estates have benefited from Darrow's purchase program. The surcharge would compensate the estates for additional bene-

fits they might have received had Darrow acted properly. Aside from the question of Colonial's influence on the "market,"[6] Miss Johnson's advice to Darrow with respect to the timing of, and prices for, his purchases necessarily was in conflict with her own interest as a trader in the over-the-counter market.[7] In any event, systematic trading by Miss Johnson and Kulp, directly or through Colonial, was bound to interfere with Darrow's opportunities to make the favorable purchases which Miss Johnson or Colonial appropriated for their own account, and Darrow's common practice to pay Miss Johnson or Colonial in advance of delivery tended to accentuate this conflict of interest. As already noted above (pp. 7–9, *supra*), Miss Johnson and Colonial generally purchased securities at less than Darrow's prices and in their numerous sales to him they sold at a profit, and these include securities which

[6] There is testimony in the record to the effect that (R. 160–161): "While Colonial was active, brokers contacted it regarding the purchase and sale of bonds. As a result of those contacts, bonds were sold to Darrow and this represents a substantial portion of the bonds he bought. Brokers who wanted to sell bonds would contact Colonial, find out the price, and then the bonds would be sold to Darrow. Apparently, Colonial was the source of market information or clearing house for the bonds of the subsidiaries."

[7] According to Darrow's own testimony (R. 211), when bonds did not come in fast enough, he frequently discussed with Miss Johnson whether the price was too low, and after a new price was established, anybody who offered bonds, including Johnson and Colonial, could get that price. That price would continue in effect until Johnson and he got together and changed it.

Miss Johnson had purchased from bondholders who had come to Darrow's office to sell their bonds. The acquisition of the securities in the Andresen trust sold at the judicial sale, described above (pp. 8–10, *supra*), provides a graphic illustration in point.

As found by the Special Master (R. 514), Darrow's attitude was that "their [Miss Johnson's or Colonial's] profits, if any, on sales to him, were none of his concern" and that "he considered the price asked by Miss Johnson a 'personal' matter." The fiduciary standards by which a reorganization trustee's conduct must be measured, we submit, cannot condone that attitude. Cf. *Meinhard* v. *Salmon*, 249 N. Y. 458, 164 N. E. 545 (1928).

3. The cases cited by counsel for Darrow and relied upon by the court below (R. 686–689; 184 F. 2d 1, 7–9) do not in our view support the decision below, but merely stand for the general proposition, which we concede, that a trustee is only required to exercise reasonable care and prudence in the administration of his trust and that he is not subject to surcharge for the wrongful conduct of his employees where such misconduct has occurred without the trustee's fault or neglect and through no lack of proper supervision. However, in relieving the trustee of any liability on the undisputed facts in the instant case, the decision of the court below is inconsistent in principle with the cases holding that a trustee must be sur-

charged for injury resulting from his negligence in supervising his employees. *Cf. Carson, Pirie, Scott & Co.* v. *Turner,* 61 F. 2d 693 (C. A. 6); *In re Curtis,* 76 F. 2d 751 (C. A. 2).

The earlier decision of the court below in *In re Breger Kosher Sausage Co.,* 129 F. 2d 62, is distinguishable on its facts and does not appear to support so sweeping a holding as that involved in the instant case. However, the court's reliance upon it as holding that a trustee who does not personally profit cannot, as a matter of law, be held accountable for the profits which he knowingly permits his employees to realize emphasizes the sweeping character of the decision below and consequently the need for granting the writ.

4. Insofar as the court's holding is based on lack of precedent for surcharging the trustee for the profits realized by his employees, it ignores the extensive powers of a bankruptcy court over the conduct of fiduciaries. As this Court has pointed out in *American United Mutual Life Ins. Co.* v. *City of Avon Park,* 311 U. S. 138, 146:

> Where * * * investigation discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against an inside few, or of one class of investors from the encroachments of another, the court has ample power to adjust the remedy to meet the need. * * *

> That power is ample for the exigencies of varying situations. It is not dependent on express statutory provisions. It inheres in the jurisdiction of a court of bankruptcy.

In enforcing this standard of fiduciary responsibility, the bankruptcy courts have applied a variety of appropriate sanctions.[8] Under the undisputed facts of this case, surcharging the trustee for profits made by his advisers is entirely appropriate. The bankruptcy court is not required to measure the precise extent of injury to the estates by determining which aspect of the reorganization has been corrupted by the selfish counsel of the trustee's advisers and which has not. Administratively, such a task is not feasible since "the incidence of a particular conflict of interest can seldom be measured with any degree of certainty." *Woods v. City National Bank and Trust Co.*, 312 U. S. 262, 268. *Cf. Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 323. Such is particularly the case where, as here, the manifestations of conflicting interests were not occasional but persisted over a period of

[8] See, for example, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, subordination of parent's claims against subsidiary; *Woods* v. *City National Bank and Trust Co.*, 312 U. S. 262, denial of compensation; *Young* v. *Higbee Co.*, 324 U. S. 204, accounting for profits; *In re Norcor Mfg. Co.*, 109 F. 2d 407 (C. A. 7), limitations of claims to cost; *In re Realty Associates Securities Corp.*, 56 F. Supp. 1008 (E. D. N. Y.), disqualification from serving on a committee; *In re Schroeder Hotel Co.*, 86 F. 2d 491 (C. A. 7), enjoining communications with security holders.

years.[9] The profits realized by Darrow's subordinates, with Darrow's aid and acquiescence, provide both an equitable and appropriate determination of Darrow's liability to the estates for the grave and, in a very real sense, the immeasurable harm which neglect of his duties and responsibilities has occasioned. He cannot now defeat that liability by putting the estates to the risk of proceeding directly against his advisers or of establishing the extent of their liability.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

Respectfully submitted.

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[9] The period of the transactions involved in this case runs from the time of Darrow's appointment in 1935 through December 31, 1941, R. 432–476).

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